

China's Stock Market Rally and BOP – How Sustainable?

By John Greenwood

Introduction and Overview

- On the face of it, China seems to have been easing monetary policy in the past year or so.
- There has been a series of announcements from the People's Bank of China to the effect that rates are being cut, money is being injected into the market, or the reserve requirement ratio (RRR) has been cut, or special measures are being used to support specific sectors.
- At the same time the broad money supply (M2) has accelerated from 8.4% year-on-year in October 2021 to 12.1% in October 2022.
- In addition, encouraged by the prospect of the Zero Covid policy being eased more quickly than many had dared to hope, the stock market has rallied sharply from its trough on October 28.
- The first section of this Newsletter investigates whether the recent stock market rally is sustainable.
- The second section of this Newsletter analyses China's balance of payments.
- The current account surplus is necessarily matched by a financial or capital account deficit.
- What is the nature and composition of these financial/capital outflows? How do they combine with the interventions by the authorities in the foreign exchange market?
- Based on our observations and the logic of the situation, what can we say about the sustainability of China's external surpluses or the future strength of the RMB?
- The conclusions are that the stock market may not be as strongly underpinned as the vigour of the recent rally might suggest, and the balance of payments imposes some significant constraints on China's policy managers going forward.

International Monetary Monitor Ltd

*The IMM Newsletter offers economic research written by John Greenwood, founder and Chief Economist of International Monetary Monitor Ltd. John was also the publisher, editor and lead author of **Asian Monetary Monitor**, a bi-monthly publication that he operated for 20 years from Hong Kong between 1977 and 1996. He was a pioneer of monetary research in Asia. From 1999 to 2021 he was Chief Economist at Invesco, based in London.*

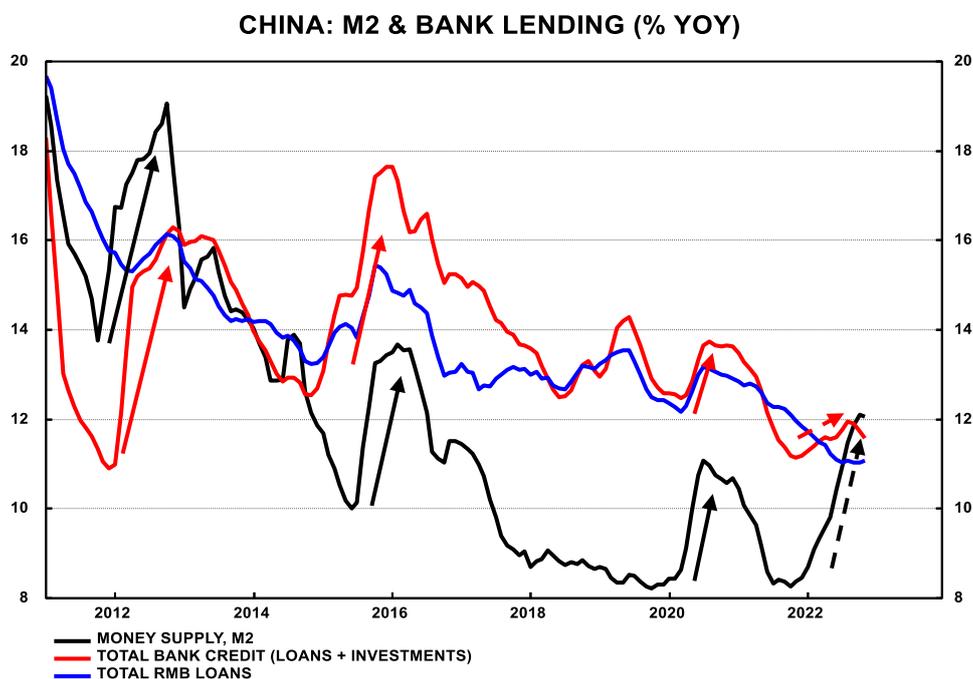
To access my research please email your request to IMM@eri-c.com

1. How Much Easing has there Really been?

Since late 2021 until the present the Chinese central bank, the People’s Bank of China, appears to have been easing monetary policy. Not only has there been a series of announcements of easing measures (interest rate reductions, cuts in the reserve requirement ratio or RRR, and special measures to support specific sectors), but in addition the broad money supply as measured by M2 has accelerated from 8.4% year-on-year in October 2021 to 12.1% in October 2022, as shown in Figure 1 below.

Remembering that Japan’s asset bubble in the 1980s came on the back of a similar upswing in M2 – from 8.7% year-on-year in February 1987 at the time of the Louvre Accord to 12.3% by November 1987 and subsequently to 13.1% in April 1990, one might think that China’s asset prices should be more favourably affected than has so far been the case. Of course, there are many differences. In Japan’s case there was a far-reaching liberalisation of financial markets including non-bank lending activity that prompted widespread leveraging up and a near-mania of “zaitech” or financial engineering, whereas in China today the clamp-down on the property market and other sectors implies that leverage is heading in the opposite direction.

Figure 1. China’s M2 Growth Rate has Accelerated from 8.4% to 12.1%, but Bank Lending has not Accelerated



Comparing the current monetary acceleration with recent episodes in China, what is interesting -- and different -- about this episode of easing is that while each of the three prior episodes of monetary acceleration (arrowed in Figure 1) were preceded or accompanied by some upturn in bank lending or bank credit growth, on this occasion

M2 has accelerated without any accompanying upswing in bank lending (in blue) and only the mildest upswing in bank credit growth (in red).

Short-term interest rates – the ones that the PBOC can directly control – have declined by a modest amount (Figure 2), and it may be the case that monetary policy easing still has further to go. However, this has to be balanced against the fact that in terms of interest rate reductions, the latest episode of easing mostly compares less favourably with the previous three episodes of easing (Figure 3).

Figure 2. Short-term Interest Rates Declining
CHINA: PBC AND MARKET INTEREST RATES

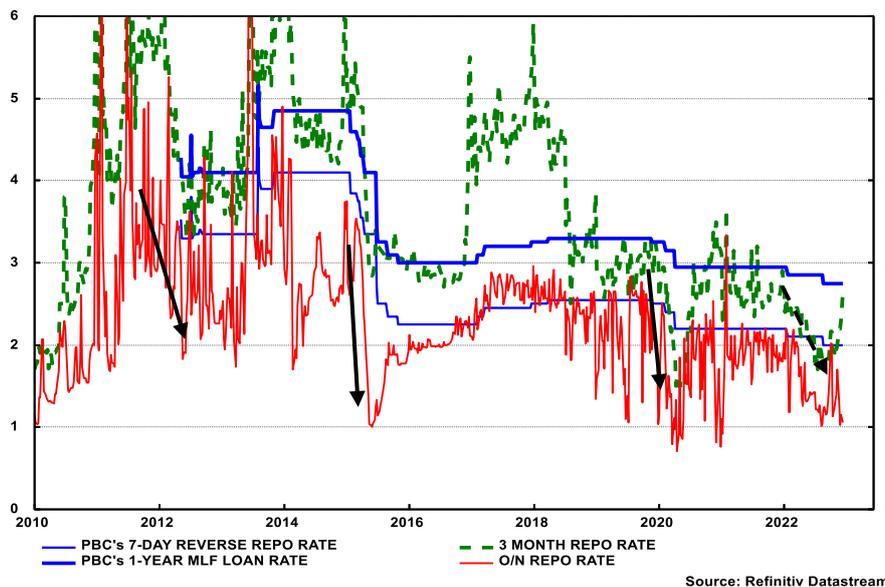


Figure 3. Comparison of Current Monetary Easing with Prior Episodes

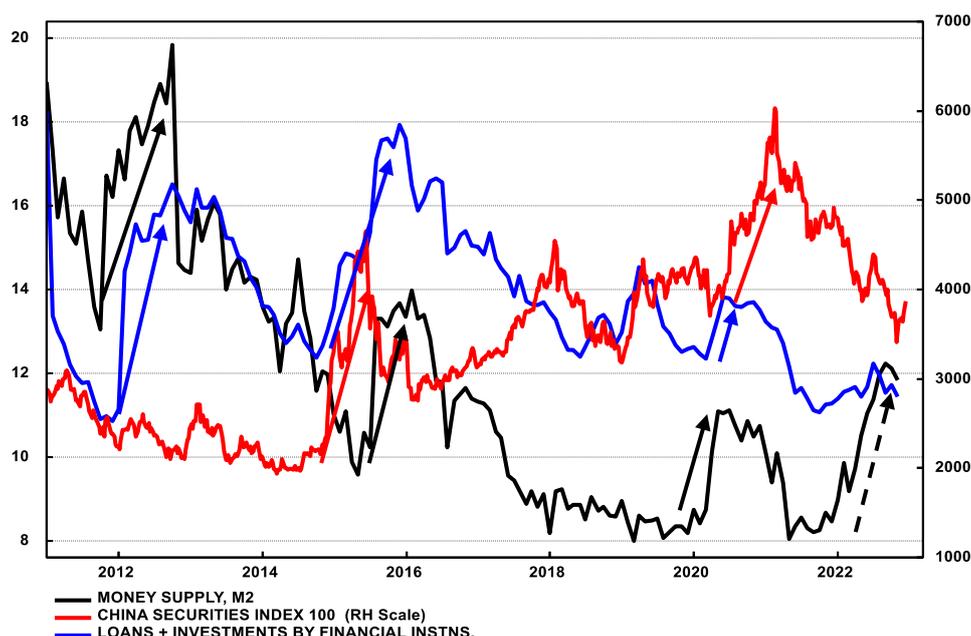
M2 Growth (%YOY)	O/N Repo	7-day Repo	3-m Repo	1-Year MLF
Sept 2011-Sept 2012: 13.8% to 19.1% +5.3 ppts	-200 b.p.	N/A	-300 b.p.	N/A
Jun 2015-Jan/Mar 2016 10.1% to 13.7% +3.6 ppts	-250 b.p.	-185 b.p.	-315 b.p.	-185 b.p.
Jan 2020-Jun 2020 8.4% to 11.1% +2.7 ppts	-180 b.p.	-30 b.p.	-50 b.p.	-35 b.p.
Oct 2021-(Oct 2022) 8.4% to 12.1% +3.7 ppts	-100 b.p.	-20 b.p.	-110 b.p.	-20 b.p.

Figures for interest rates are rounded.

Although China's stock markets have bounced strongly from their October 28 lows on justified expectations of an easing of the Dynamic Zero Covid strategy, a longer-term perspective suggests that to generate a sustained bull market in asset values including the stock market requires more than just an easing of Covid restrictions and increase in M2 growth.

Figure 4. China's Stock Markets Respond more to Bank Credit Growth than M2 Growth

CHINA: CSI-100 INDEX, M2 & BANK CREDIT (% YOY)



As shown in Figure 4, in 2011-12 M2 and bank credit (mainly in the form of bank holdings of securities) increased their year-on-year growth rates by 5-6 percentage points each, but the Chinese stock market went nowhere. The background was that between November 2008 and August 2009 the stock market had already surged by 115% thanks to the fiscal stimulus and monetary expansion policies announced and implemented from the final quarter of 2008, and in addition the euro-area debt crisis was just moving into its most intense phase. On this occasion, external and sentiment factors dominated over domestic liquidity.

In 2015-16 bank credit surged, followed by the stock market, and finally M2 growth picked up, in effect validating a move in asset prices that had already taken place. These changes were accompanied by the largest and most abrupt cuts in interest rates during the decade (see Figures 2 & 3), cuts which had been prompted by the steep fall in commodity prices – especially energy prices – that occurred in the final quarter of 2014 but persisted until February 2016. This time, domestic and external factors played an equal role.

In 2020 after the onset of Covid and the lockdowns that followed, M2 growth increased by just 2.7 percentage points, contemporaneously with an even more modest uptick in bank credit growth, but stock market prices increased much more,

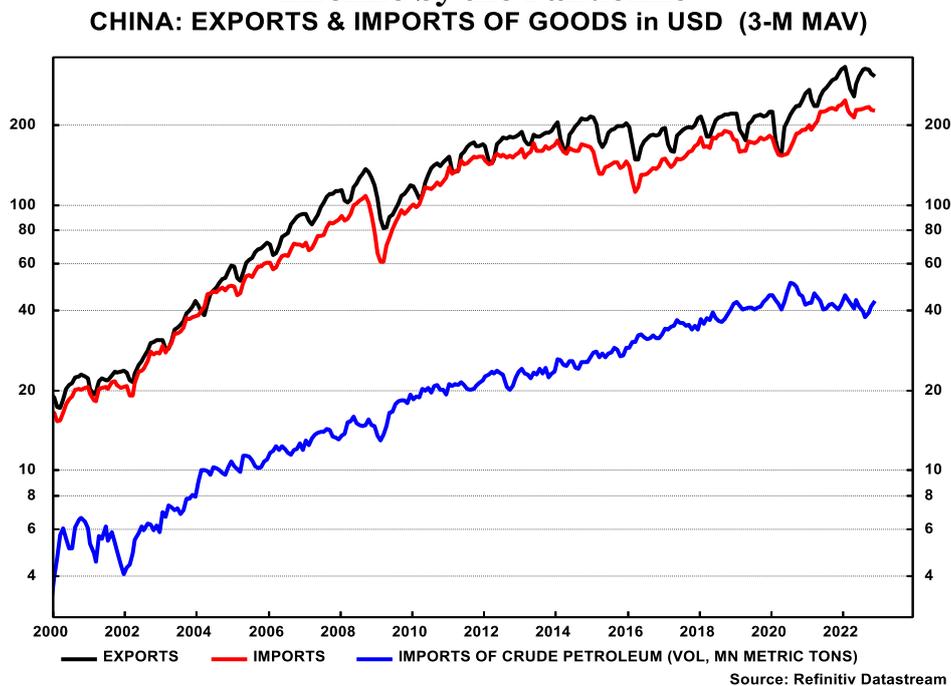
helped no doubt by the strong growth of stock markets abroad. Once again, overseas sentiment played at least a large a role as domestic improvements in liquidity.

These three case histories serve to illustrate that the Chinese stock market is by no means independent of the sentiment and trends in foreign equity markets. To generate a bull market in China **either** requires a huge boost to domestic money growth (of the kind seen in 2008-2010 when M2 accelerated from 15% to 25% for nearly two years), **or** it requires foreign equity markets to be vigorously buoyant and domestic conditions to be at least supportive. On that basis we must conclude that although Chinese stock markets have enjoyed a good run since late October, the possibility for them to continue in bullish mood is (a) limited by the relatively small improvement in domestic liquidity conditions, and (b) likely to be sensitive to any deterioration in foreign equity markets.

2. External Trade and the Balance of Payments

China's exports boomed between 2000 and 2008, but after the GFC their growth rate slowed until they virtually stalled between 2014 and early 2020 at \$200 billion per month (Figure 5). With the onset of Covid-19 and the big shift to spending on goods rather than services during lockdown in developed economies, China's manufacturing sector was thrown a lifeline, and exports surged, expanding from about \$200 billion per month to around \$300 billion in the second half of 2021 and 2022.

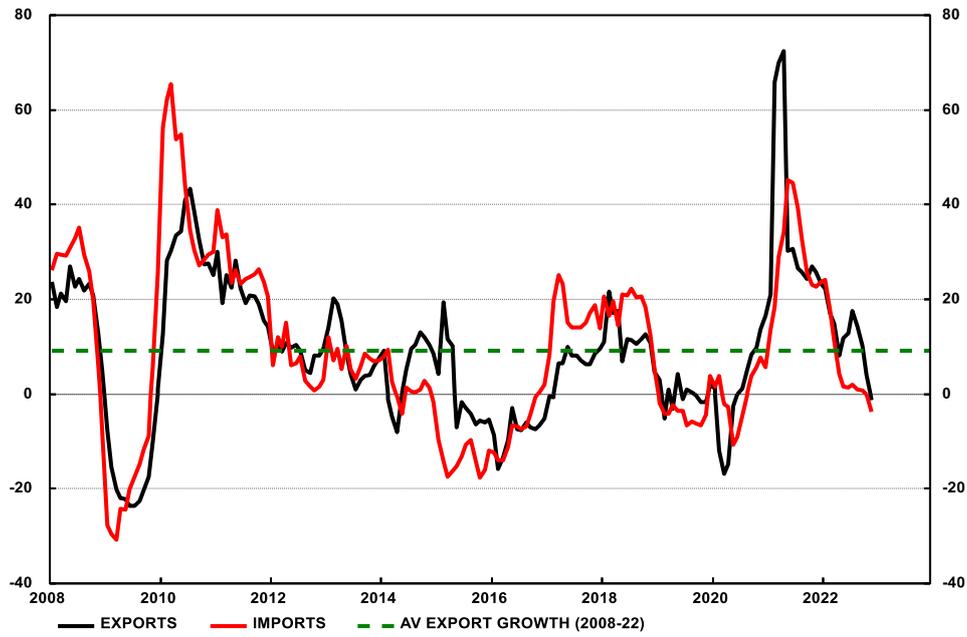
Figure 5. China's Exports had Stalled after the GFC, but were Handed a Lifeline by the Pandemic



With the domestic lockdowns in China under the Zero Covid strategy the economy has slowed, as reflected in the decline in oil import volumes and the slower growth of imports, both shown in Figure 5. In this section we examine the consequent widening of the trade surplus and its implications for the overall balance of payments.

The first thing to note is the dramatic slowdown in export growth in the last decade and a half. From a growth rate of 26.2% p.a. between 2000 and the start of 2008, export growth has slowed to 9.0% p.a. in 2008-2022, almost one third of the pace.

Figure 6. Export Growth has Slowed over the Past 15 Years
CHINA: EXPORTS & IMPORTS OF GOODS in USD (%YOY, 3MAV)



Currently both exports and imports have slowed to negative growth rates on a year-on-year, 3-month moving average basis (Figure 6). Doubtless this is starting to reflect the impact of higher world energy prices crowding out other types of purchases such as China's manufactured goods, but it probably also reflects a drop in orders due to the on-coming recession in many western developed economies.

Figure 7. Current Account Surplus Mirrored by Financial/Capital Outflows

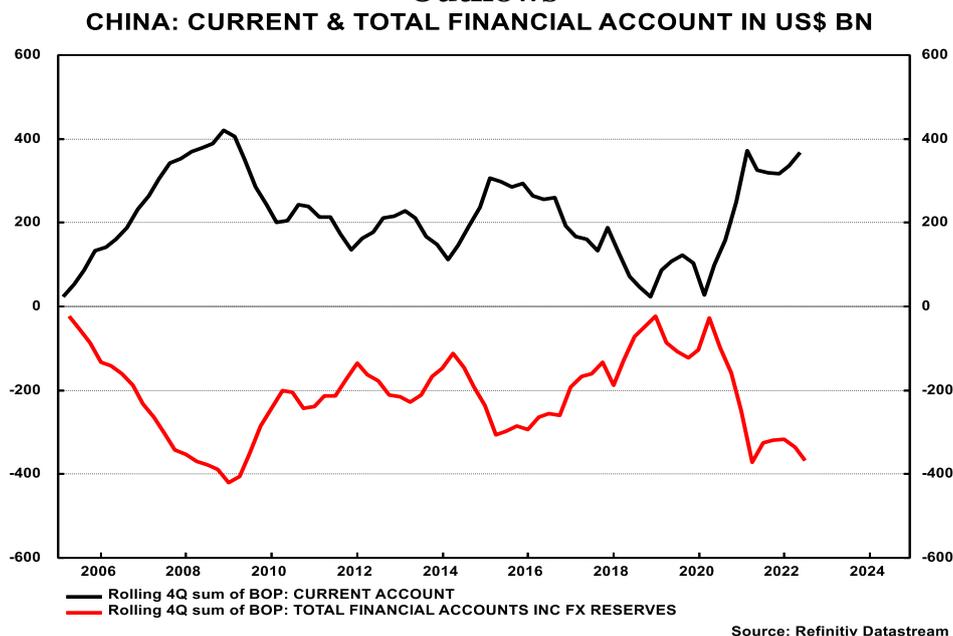


Figure 7 shows the overall current account, which adds services and some financial payments such as dividends and interest, to the trade account. From this we can deduce the overall financial and capital payments, which must – after taking into account errors and omissions -- exactly mirror the current account but with the opposite sign. Since there has been only moderate intervention activity affecting China’s official foreign exchange reserves, the upswing in the overall current account since the start of the pandemic from less than \$30 billion in 2020 Q1 to nearly \$370 billion in 2022 Q2 (all figures on a 4-quarter rolling sum basis) is now enabling China’s private and semi-official sectors to build assets abroad at a formidable rate.

Figure 8. Financial Flows Adding to China’s Asset Claims Abroad except when Carry Trades were Repaid in 2015-16

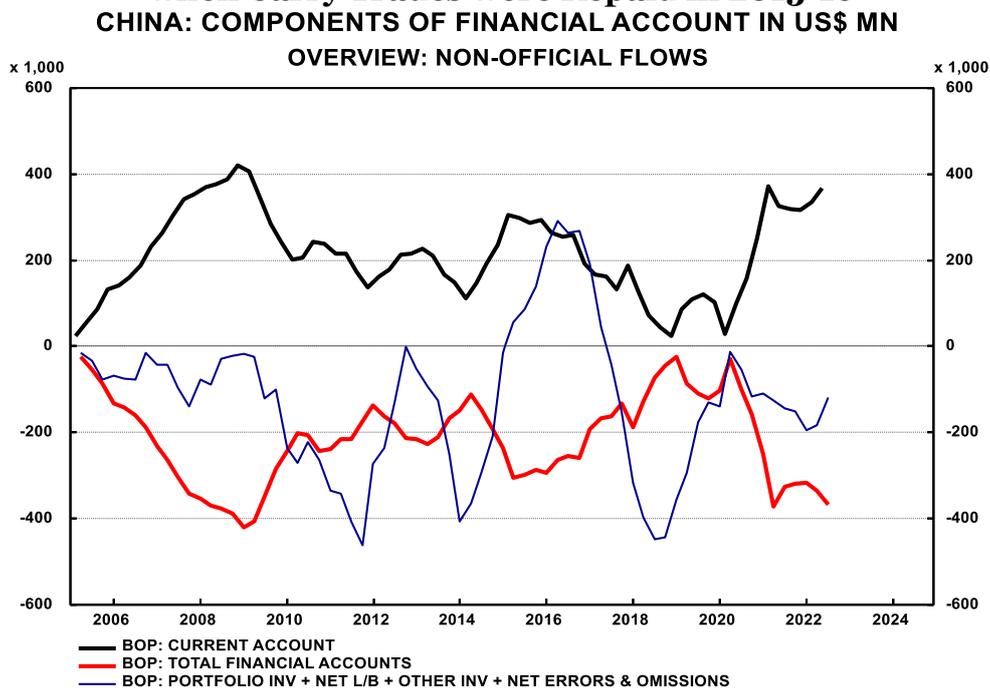
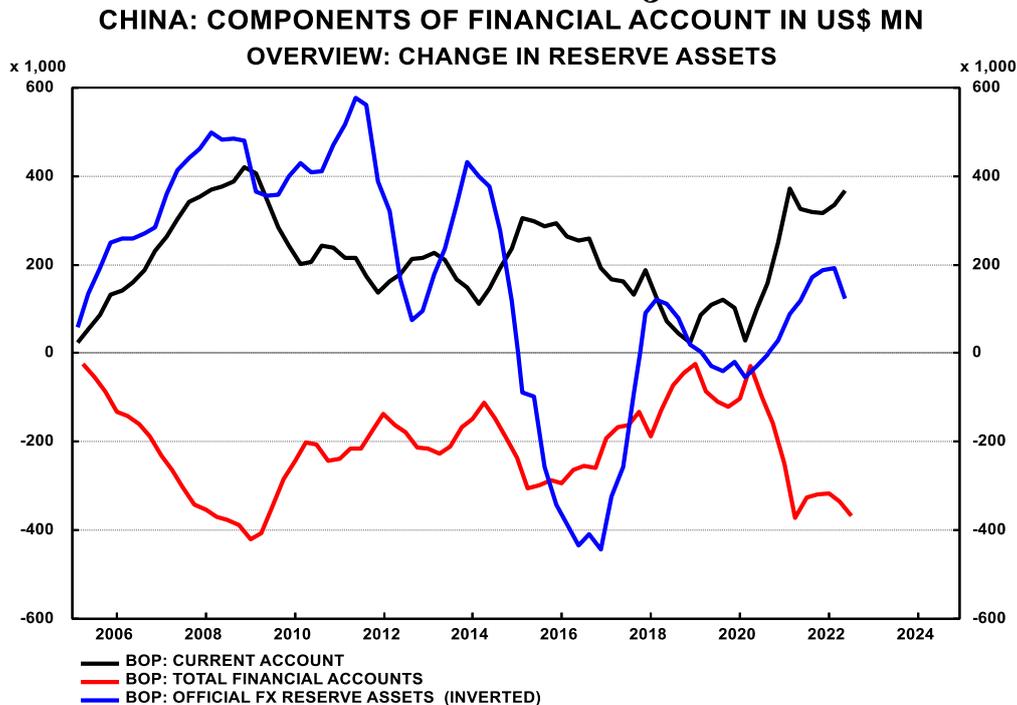


Figure 8 adds in the contribution of the private and semi-official sector and shows that it is considerably more volatile than the overall financial account. It consists of net portfolio investments inwards and outwards, the balance of net lending and borrowing by residents and foreign entities, other investments (including FDI) and net errors and omissions.

An important episode to understand was the carry-trade conducted by Chinese mainland companies in 2011-14 and its unwind in 2015-16. During the GFC from June 2008 until June 2010 the Chinese authorities had re-pegged the RMB exchange rate at 6.83 per USD. Once the crisis seemed to have passed the RMB was again gradually managed upwards against the USD, only now Chinese companies started to borrow foreign currencies at very low interest rates and convert the proceeds to RMB for a double gain – the appreciation of the RMB and the interest differential between rates available on RMB deposits and the rates available on foreign currencies. As soon as the authorities allowed the RMB to depreciate slightly in August 2015, those trades were urgently repaid. In Figure 8 those repayments show up as a financial account surplus – a reduction of liabilities – and in Figure 9 the official foreign

exchange reserves declined by about \$1 trillion as the authorities stepped into the foreign exchange market to supply the USD and prevent the RMB from depreciating.

Figure 9. China’s Fx Reserves Declined by \$1 trillion when the Carry-Trade Ended in 2015-16



Source: Refinitiv Datastream

Note that in BOP accounting additions to reserves are normally shown as a negative item, i.e., acquisition of overseas assets or an “outflow”. In this chart I have inverted them to show the big decline in 2015-16.

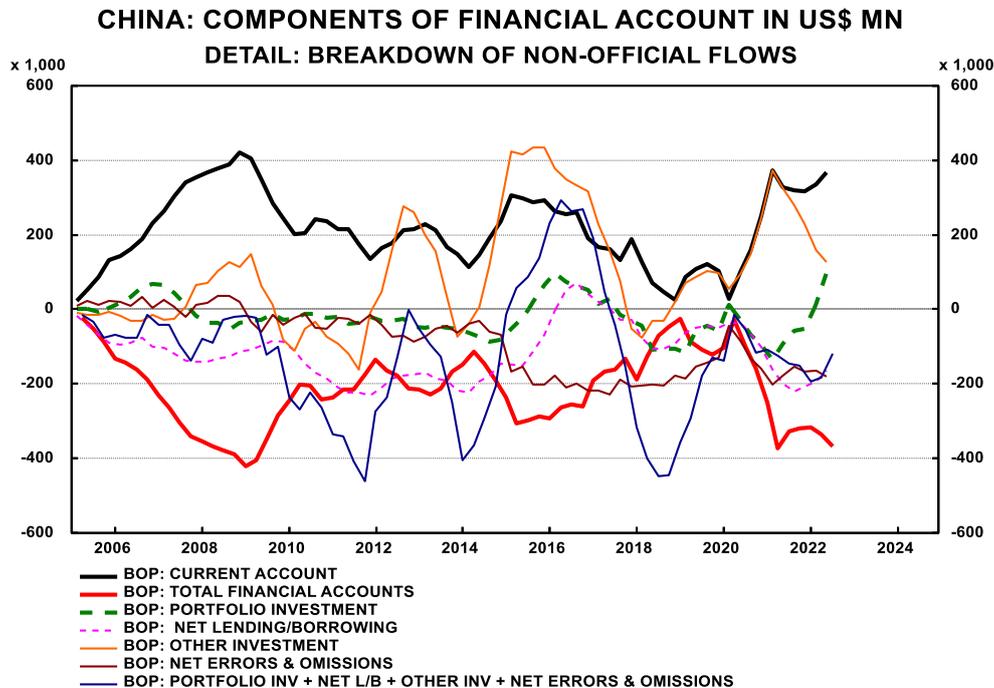
The lesson of the carry trade episode is that no government or central bank should take the other side of speculative private sector trades, which means it was a mistake to allow the “carry” to build up in 2011-15, and in turn it was a mistake to offer a one-way bet to domestic residents on the appreciation of the RMB.

Now that the external accounts have returned to a more normal position, the financial account outflow in 2022 Q2 (on a 4-quarter rolling sum basis) consisted of a private or semi-official outflow of \$120 billion and an increase of reserves (i.e., an “outflow”) of about \$125 billion, for a combined total of \$245 billion. Capital account flows and other items made up the remainder of the \$367 billion outflow.

For completeness we show in Figure 10 the non-reserve or semi-official components of the financial account of China’s balance of payments. The current account surplus (in black) and the mirror-image line showing the financial and capital outflows (in red) matching the current account are shown in the same colours as previously. The financial account is then broken down into four non-official elements: net portfolio investment, net lending or borrowing, net other investments (which include FDI or direct equity investment, but also some banking transactions), and the net errors and omissions which are normally a residual or balancing item. The sum of all these

items is shown as a thin dark blue line, as in Figure 8. Finally, the official foreign exchange reserves (shown inverted in Figure 9) are omitted from this chart.

Figure 10. The Bundle of China’s Non-official Outflows Contributing to the Overall Financial Account Deficit.



Since all these outflows represent the acquisition of foreign assets by residents or resident entities of China, a continuing current account surplus implies that China will continue to improve its overall Net International Investment Position for several, possibly many, years to come. This situation is only likely to change if some fairly significant structural changes occur.

For example, China’s per capita income could grow to a point where China is no longer sufficiently competitive to be the workshop of the world and other nations (such as India, or smaller south-east Asian nations such as Indonesia and Vietnam) take over this role. This kind of change is likely to be several decades away.

Another structural change could be due to the ageing of China’s population, reducing the ratio of working people to the full population, reducing the national savings rate and requiring substantial resources to support elderly dependents. Again, while not imminent, this kind of change is already evident in Japan and could creep up on China relatively quickly according to UN and other demographic forecasts.

The conclusions of this analysis of China’s current and financial accounts are that while China’s external balance of payments appear solid, there are limits on the country’s freedom of action in this area. In particular, as long as other countries’ interest rates remain below China’s rates, it would not be wise to allow the build-up of another large carry-trade position. This means that the RMB cannot be allowed to embark on a one-way journey of appreciation as it did on 2011-2015, and the Chinese

authorities will need to continue to allow or encourage enough 2-way flexibility in the FX price of the RMB to discourage a large pro-RMB “carry” to build up.

Summary and Conclusions

- On the face of it, China seems to have been easing monetary policy in the past year or so.
- There has been a series of announcements from the People’s Bank of China to the effect that rates are being cut, money is being injected into the market, or the reserve requirement ratio (RRR) has been cut, or special measures are being used to support specific sectors.
- At the same time the broad money supply (M2) has accelerated from 8.4% year-on-year in October 2021 to 12.1% in October 2022.
- In addition, encouraged by the prospect of the Zero Covid policy being eased more quickly than many had dared to hope, the stock market has rallied sharply from its trough on October 28.
- The first section of this Newsletter concluded that the recent stock market rally is only sustainable if more liquidity is injected and/or foreign markets rally strongly.
- The second section of this Newsletter analysed China’s balance of payments.
- The current account surplus is necessarily matched by a financial or capital account deficit.
- These financial/capital outflows have been fairly erratic, requiring occasional large-scale interventions by the authorities.
- Experience in recent years suggests that China cannot assume its balance of payments will take care of itself.
- Based on our observations and the logic of the situation, the sustainability of China’s external surpluses are guaranteed for the present, but significant and entirely plausible structural changes could undermine the future strength of the RMB.
- The conclusions are that the stock market may not be as strongly underpinned as the vigour of the recent rally might suggest, and the balance of payments imposes some significant constraints on China’s monetary policy managers going forward.

Disclaimer

The information in this report has been prepared by International Monetary Monitor Ltd. (IMM). Materials available herein have no regard to the specific business objectives, financial situation or particular needs of any specific recipient. The research is published for information purposes and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. The opinions, estimates and projections in this report reflect the current judgment and express views of the author as at the date of the report. They do not necessarily reflect the opinions of IMM and are subject to change without notice. Unless specifically stated otherwise, all price information is indicative only. No representation or warranty, either expressed or implied, is provided in relation to the accuracy, completeness or reliability of the materials, nor are they a complete statement of the securities, markets or development referred to herein. The material should not be regarded by recipients as a substitute for the exercise of their own judgment. The financial instruments discussed in this report may not be suitable for all investors.

Copyright © 2022 International Monetary Monitor, not for distribution without express permission.
Registered office: c/o PKF Littlejohn, 15 Westferry Circus, Canary Wharf, London E14 4HD, UK.